POINT OF VIEW

Oil in the 1980's: A Question of Supply

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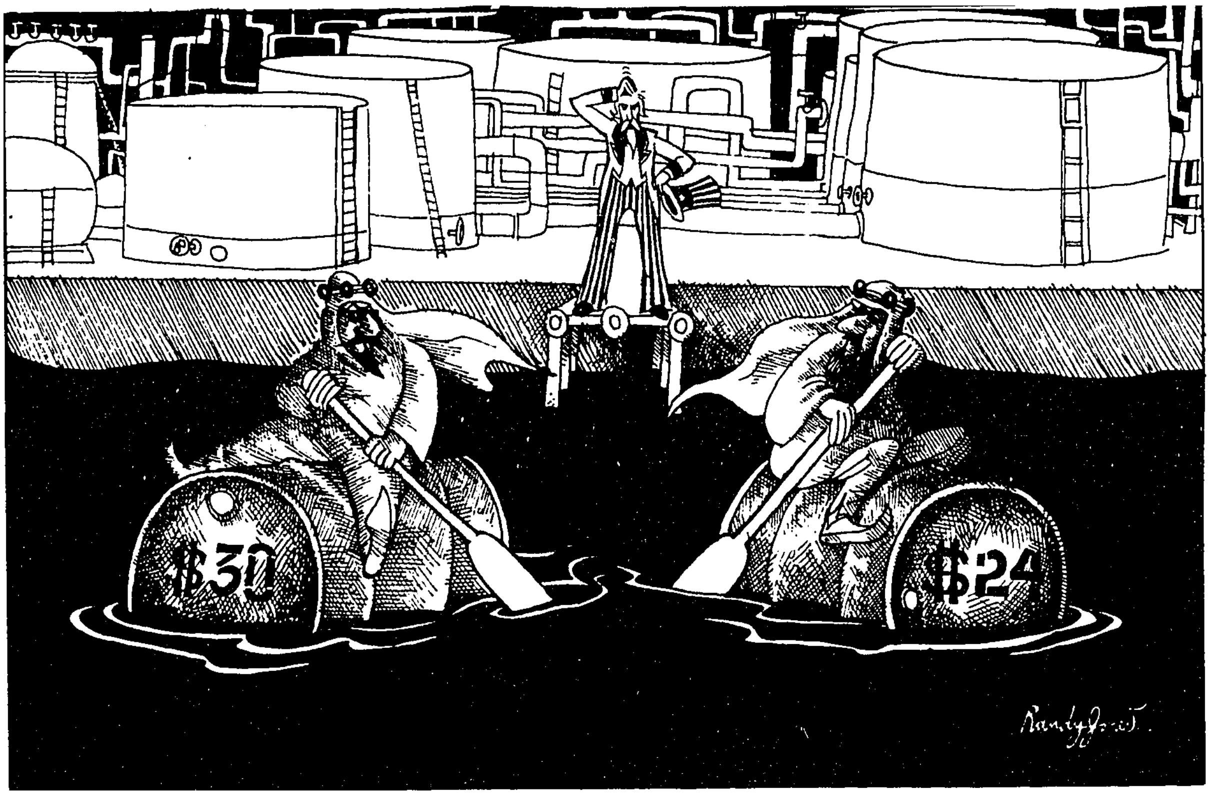

The Organization of Petroleum Exporting Countries has ended its second decade on a note of uncertainty. Its longest ministerial meeting, in Caracas last month, came up with no single price, and instead continued the confusion that prevailed through most of 1979.

Some of the alignments at Caracas were predictable. As usual the moderates were led by Saudi Arabia. Once again Libya and Iran vied with each other as hawks: the change from Shah to Ayatollah has not affected this particular alliance. The Saudi offering on the altar of OPEC unity, of a preconference price rise from $18 a barrel to the prevailing $24 level, was rejected by the hawks who re-established the previous differential by raising their prices in turn. In the end, the 13 ministers adjourned without even the "two-tier" price system of December 1976, or the largely illusory "price ceiling" of April 1979.

This outcome is remarkable, because OPEC has differed fundamentally from other cartels. The classic cartel establishes its ascendancy by cutting production to amounts previously agreed among the members. OPEC has never worked out such a production schedule; any attempt to do so would have broken down in hopeless haggling. Instead the oil cartel hit on the disarmingly simple device of setting the price directly — with appropriate small differentials for gravity, sulfur content and transport costs. It then proceeded to carry out even the steepest of price rises in goose-step formation. And at each turn it let the customers themselves decide how much they cared to buy at the given price level. In sum, OPEC was a price cartel, not a quantity cartel. Hence its failure at Caracas to set any price at all is surely a landmark of sorts.

There are three reasons, however, why it would be vastly premature for oil consumers to gloat over the cartel's failure, or even to breathe any sigh of relief at its seeming disarray. First, the argument at Caracas was not between those who would keep or raise the price, let alone lower it. The division was among those who wanted to raise it, as did the Saudis, to double its 1978 level, or, as the Libyans, to 2¼ times or more.

This division, in turn, stemmed from different estimates of demand in the months ahead. Throughout 1979, sales of OPEC oil held steady at about 30 million barrels a day — although contract prices had doubled and spot prices tripled or more. For over a year, the frantic scramble by old and new buyers to build up inventories made up for any reduction in actual consumption.

Libya's Muammar el-Qaddafi, by setting his price at $30, did little more than average out the previous contract and spot prices for his nation's high-grade crude. Evidently he is betting that the buying spree will continue. Saudi Arabia's Ahmed Zaki Yamani, on the contrary, expressed his confidence that by winter's end the spot market will have dried up, demand will have fallen in line with reduced consumption and the hawks will have to come down to his $24 level. He also hopes that Saudi Arabia's continued production of 9.5 million barrels daily (as against the "normal" 8.5 million) will encourage this calming of the market — a hope that eluded him when Saudi production was originally raised in July 1979.

The second reason consumers should be wary lies in the very process that raised prices to such giddy heights in 1979. OPEC's price cartel, which held up from October 1973 to the fall of 1978, was replaced at least temporarily by a system of accidental or deliberate production cuts. The first and biggest cut came when Iranian production stopped in late 1978 and then resumed at about half its old level. The cut was "accidental" in the oil context: the mobs in Teheran had taken to the streets to drive out the Shah, not to drive up oil prices.

But this Iranian crisis, hobbling production in OPEC's second largest producer, had the effect of testing the short-term elasticity, or, as it turned out, inelasticity, of global oil demand far more boldly than OPEC's cautious managers had ever dared. The test showed that demand was virtually inelastic in the short run — indeed it turned out to be fractionally higher for 1979 than for 1978, even though prices doubled or in part tripled. For Iran, specifically, it meant that the 3.5 million barrels it produced daily for most of this year earned it more than did its 5.6 million barrels of daily output in 1978.

For OPEC's hawkish ideologues in Tripoli and elsewhere, the lesson was plain. Their pious sentiments about saving the oil for their children or grandchildren now had the support of hardheaded arithmetic. The notion that oil was more valuable if kept underground was becoming a self-fulfilling prophecy.

For much of 1979, Libya and other hawks responded to any temporary slackening of the market with production cuts. And these deliberate cuts had the intended ratchet effect: They maintained by design the exorbitant price levels that the Iranian crisis had established by accident. For a little while longer at least, Mr. Qaddafi can expect to ride high: His oil is highly prized in the United States, which has long been its best customer, especially in the winter months.

The real test between the Yamanis and the Qaddafis in the spring or summer of 1980 will be whether the hawks can cut production by more than Mr. Yamani can raise it. The outcome is by no means certain. Remember that at their current price levels of $30 and up a barrel the hawks can cut production by half and still make more money than in 1978. And of course, there is always the possibility of a new crisis in Iran, or some other part of the volatile Middle East doing the cutting accidentally.

One slight comfort that the oil consumers could derive from Caracas evaporated quickly. Iraq and Kuwait, usually among the price hawks, and Venezuela, which tends to take the middle of the road, at first kept their prices in line with Mr. Yamani's $24. But a week or so after the meeting, all three raised prices by $2 to $4. This meant that, just as before Caracas, the Saudis and the United Arab Emirates were the only ones at the low end of the price spectrum — and the whole spectrum had shifted upward by about $6.

And so to the third major note of caution, and one that consumers would ignore at their peril. Mr. Yamani and his Arab neighbors may be right that the wild buying spree of 1979 will soon end, that demand will find its new level well below the 30 million barrels a day of the 1976-79 period, that market forces therefore will drive down Mr. Qaddafi's $30 a barrel toward Mr. Yamani's $24, and, in sum, that the price spiral set off by the Iranian revolution will be at an end. But it would be foolish to expect the spiral now to start going in reverse, to hope for prices to go down from $24 to Mr. Yamani's $18 of last summer, to OPEC's $13 of 1978, or less; foolish in short to expect OPEC to fall apart.

OPEC did not come by its $100 billion a year in the mid-1970's, or its $200 billion last year, in any fit of absentmindedness. The sharp splits in the cartel have good economic reasons. Those members that spend or overspend their incomes, as do most of the hawks, are bent on maximizing current revenue only, whereas those that have accumulated huge international reserves (Saudi Arabia's are larger than those of the United States and West Germany combined) must also consider the effect of price rises on the health of the world economy on which the value of such assets depends. And so far the world seems to have found no better way of coping with the oil rises than inflation and recession.

Oil demand, as Mr. Yamani said at Caracas, may well "change by the end of February or the end of March," causing "a sharp drop in prices on the spot market." But this will only have the effect of restoring the Saudis to their pre-1978 position of being the cartel's price setter. Their spare capacity of two million barrels a day or so over their "normal" 8.5 million gives them a limited ability to defend that price against sharp increases. Their $57 billion in international reserves gives them a far larger power to defend that price against any precipitous drops — since they can cut production, and hence their earnings, within very wide limits while living on income. And right now their preferred price is $24.

The most important decision concerning OPEC's future will be made not in Caracas or in Riyadh, but right here in the United States. It will be our decision, as OPEC's largest customer, to reduce our appetite for oil imports.

President Carter's recent phase-out of price controls (and the import subsidy known as "entitlements") will help a little — less by stimulating production than by dampening demand. Mr. Carter's plan to apply part of the windfall profits tax to producing oil from coal or shale by the 1990's will not help at all: It will be too little, too late, and too expensive.

The recent shift of American consumers toward cars with better gas mileage will help a lot, especially if the Government shows that it means business about its mileage standards and if we start selling our bankrupt automobile plants to the West Germans or the Japanese, who already know how to make efficient cars. Doubling our gas mileage — while driving not a single mile less — would have the instant effect of cutting our oil imports by nearly one half.

West Europeans and Japanese have no choice but to depend on oil imports for most, or virtually all, of their energy needs. By contrast, our oil imports represent no more than 22 percent of total energy consumption. In fact, we still produce more domestic energy — oil, gas, coal, and so forth — per capita than the total per capita energy consumption of Europe or Japan. Our oil imports merely boost our energy consumption level from the comfortable to the luxurious — yet they amount to more than one-fourth of OPEC's sales volume. As oil prices continue to spiral upward in the 1980's, imports are getting to be an extravagant luxury indeed. For remember:

The whole might of OPEC
Would be worth not one kopeck,
If only we could toil
Without imported oil.

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